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General Business Conditions

TRADE and industrial activity has held at a high level during August. The forward movement has not been as brisk as from May through July, but a flattening out was to be expected after the rise, and as inventories were replenished. A considerable number of industries are running close to practical capacity; and although they expect to continue at high rates, further gains will be slower. The steel rate is above 90 per cent. All the industries influenced by the defense program or having British orders are busy, and even in textiles and other lines of everyday use government buying is giving support.

New construction has reached the highest volume since 1930, due both to record activity in small home building and to industrial contracts representing the beginnings of plant expansion for armament requirements. When factories are put up in new places or plants greatly enlarged, new housing has to be provided for workers. Whether home building is being rushed for fear of rising costs remains to be seen; but so far there have been few instances of marked advances in costs either in construction or the industries. The cost of living is almost static, according to the accepted indexes. This is probably the best evidence that the upswing has not yet produced any new or threatening disorder in economic relations. If orderly improvement is to continue nothing is more essential than to prevent disrupting cost increases.

Retail trade reports have been close to the best of the year, considering the season. Merchants expect their Fall business to be better than last Fall, but for the most part show little disposition to increase inventories or lengthen commitments, preferring to re-order if their expectations are realized. They are sensible of the fact that in many localities consumers will not benefit directly from the increased expenditures for armament work, but will feel only the effects of the higher taxes necessary to pay for it. Likewise the action of the markets has not provided an inducement to forward buying.

Speculative and financial activity are both at a low ebb. Prices of basic commodities, particularly foodstuffs, have sagged during the month, due partly to larger crop movements, and partly to the closing of the European continent to trade and disruption of world markets. With government loans on some of the major staples, the price level is well-supported; but the downward drift serves as a reminder that there is still a surplus problem in many commodities, a fact which those who expect price inflation should not overlook.

War Uncertainty

The most immediate uncertainty is the outcome of the attack on Great Britain. With shipments to the continent of Europe cut off and British buying vastly extended during the past few months, almost one-half of United States exports now go to Great Britain and the British Empire. They are heavily concentrated in the metal products and war supplies, and if they were interrupted the industries concerned would feel the loss severely. The steel industry is one of these, for steel exports have mounted to the highest levels on record. In June they represented 17 per cent of output, and 40 per cent of the shipments went to Great Britain. For the steel makers the outcome of the struggle is a very practical element in business calculations.

Naturally, the American people have been anxious as to the British position. If Great Britain, aided by the change in weather conditions within the next few weeks, attains a position of greater security, the future will seem much clearer and the domestic prospect less qualified. Meanwhile the confidence of the British people is making a strong impression upon sentiment here. Stock prices usually reflect the state of the public mind in times of stress. Upon the outbreak of the German massed air attacks, stocks in London declined substantially less than in New York, and they have recovered strongly, to the highest levels since the French surrender.

Delays in the Armament Program

The armament program is making progress, but more slowly than was hoped and intended. When any great project of this kind is begun expectations usually are too high at first; and many people do not understand that the job of setting the nation's factories, which have been built and equipped to make goods of peacetime use, to turning out arms and munitions is one of enormous difficulty and magnitude. It involves complex planning, new plant and machine construction, and training of labor. Some confusion in procurement policies is probably inevitable. The Defense Advisory Commission has expressed no discouragement, but on the contrary has praised the cooperation it is receiving from business men.

Nevertheless, the delay in passing legislation which will let manufacturers know where they stand as to tax deductions and other uncertainties is wholly regrettable. It slows down progress and it causes misunderstanding. Testifying before the Senate Subcommittee on Appropriations on August 20 Rear Admiral W. R. Furlong, Chief of the Navy Bureau of Ordnance, cited a case in which certain subcontractors had refused to join in a bid for the manufacture of anti-aircraft guns for destroyers because of the limitation on profits to 8 per cent, imposed by the Vinson-Trammell Act. He also cited the holding up of construction on a plant to make rolled plates and armor plates for the Navy until the manufacturer could receive definite guarantees as to depreciation rates. This testimony prompted Senator Russell of Georgia to comment that it was "unfortunate that these people were so much interested in profits". Senator Russell is co-author of the amendment to the compulsory military training bill, passed by the Senate, under which the President is empowered to take over through condemnation proceedings any existing manufacturing facilities found necessary for defense, if unable to make an agreement with the owner as to its use.

Possibly the Senator's observation was prompted by an impression that the limitation of profits to 8 per cent was in effect a guarantee of an 8 per cent return; but the public should understand that this is not the case. What manufacturers are concerned about is not to make abnormal gains out of defense work, but to avoid losses. The key question is what costs are to be allowed in computing profits. It has often been pointed out that certain expense items, including income taxes, losses in research and development, interest on working capital loans, and some others, cannot be included in costs on contracts subject to the profit limitation provisions. Chiefly, however, manufacturers want to know whether they will be allowed to charge off out of earnings the cost of new plants and machinery during the period of their useful life, which is necessarily much shorter in the case of armament production than in the manufacture of peacetime goods for which there is a continuous market. If this cost is not covered the "profits" obviously will turn into losses. They also want to know whether they will have contracts to operate their plants long enough to provide earnings from which to make the chargeoffs. Since the Government is the tax collector, and also the buyer of the product, the necessary assurances can come only from the Government.

It is these uncertainties rather than the profit limitation itself which constitute the chief block, so far as the plant capacity problem is concerned. Until they are satisfactorily cleared up the industries must take into account the fact that while profits are limited losses may run unchecked. Business men know what this means with respect to ability to attract capital or negotiate loans to finance extensions, to say nothing of their obligations to meet payrolls and preserve their assets.

Five-Year Amortization Planned

Fortunately developments during the past month encourage belief that these obstacles will be overcome. The excess profits tax bill now before the House includes a provision for amortization of expenditures for plants and machinery, certified as essential to the defense program, over a period of five years. There is so little disagreement over this provision that separate legislation embodying it evidently would pass Congress quickly, but the policy of the Administration is to combine it with the more complex and time-consuming tax proposals. Meanwhile the Comptroller General has published a ruling which permits the Government to make annual payments to manufacturers (over and above unit prices of things purchased) sufficient to charge off essential plant expenditures within the five-year period. This is subject to certain agreements with respect to the disposition of the plant after the five years, if it is still useful.

In one way or the other, therefore, the five-year amortization provision seems to be reasonably assured; and the Defense Advisory Commission is authority for the statement that many manufacturers are going ahead with surveys, designs and other necessary preliminary work at their own risk and expense. Where this is the case they will be able to move rapidly when the necessary contracts can be made. Thus the time now being consumed is not to be regarded as wholly lost.

Under the bill now being considered, the profit limitations of the Vinson-Trammell Act will disappear with the passage of the new tax measure, being superseded by the excess profits tax. To be sure, the prospective heavy increases in taxes stand as a possible deterrent to new investment, and an obstacle to building

up reserves against potential losses. As was pointed out in these pages last month, the central economic question before the country is whether the defense program will be carried out by *increasing* production and employment, above present levels, or whether the armaments will be provided by *diverting* manpower and capacity from present activities, leaving the country still with huge unemployment and a low national income. We have the manpower and the potential capacity to follow the first course. We can increase production and income; and except possibly for priorities at bottlenecks we do not need to repress other activity to provide for defense. Legislation passed now should not be repressive, but should encourage production and enterprise. As the Congress gives further consideration to both the tax and conscription measures this is the principle which should be kept in mind.

Such threats to the continuance of private enterprise as that contained in the Russell-Overton amendment, referred to above, have the effect of discouraging enterprise. The question is how to do most effectively the job that has to be done. To examine it from this point of view is to show that the supposed analogy between drafting men and drafting industries in fact does not exist. The purpose of conscription of men is to provide for the fighting forces in a way that authoritative opinion considers the most effective and the least disturbing to industrial production. Upon the question whether plant conscription would promote production, however, most experienced opinion would hold exactly the opposite. If the Government takes over plants it will have to manage them, and who could possibly manage them as well as the men who have come to the top through competition, and who have a stake in the business and normal profit incentives? The Government already has ample power and is taking ample steps to protect the public interest in defense contracts. There has been no showing, on the evidence, that it need make threats to get the work done, or rely upon anything but fair and businesslike dealing.

Course of Defense Expenditures

Actual disbursements for defense, taken from the Treasury statement, totaled $179,000,000 in July and $162,000,000 in August through the 26th, which is about the same daily rate. This is far below the average projected for the fiscal year 1941. On August 9 Secretary Morgenthau testified before a meeting of House and Senate committees that the Treasury expected defense expenditures to approximate $5,000,000,000; this is an average of above $400,000,000 monthly, and if the estimate is reached the level next Spring will have to be increased to $500,000,000 or higher. This does not include costs to be incurred under the compulsory training act and for the active service of the National Guard. Possibly, however, the addition of these costs will be offset by inability to raise other expenditures as rapidly as anticipated.

Despite higher taxes the Secretary estimated that the year's deficit will be larger than the defense spending. He estimated total expenditures at $12,058,000,000, receipts at $6,367,000,000, the deficit at $5,691,000,000. If $2,000,000,000 of this is covered by receipts in the social security and other trust accounts, and sales of baby bonds, and the scheduled repayment into the Treasury of $700,000,000 of the capital of certain Government agencies is carried out, roughly $3,000,000,000 will be left to raise by public offerings of Treasury securities. To both disbursements and borrowing must be added further sums covering activities of the R.F.C. and other agencies, financed by the sale of their own obligations.

These are enormous sums to pour into the markets, representing demands for goods, materials and labor, and the appropriations show that in the following years expenditures will be even larger. It is not to be expected that this spending will assure a continuously stable business upon a high level. There were substantial variations in business during the World War, even when the war industries were continuously at capacity; the business trend was downward during most of 1917. Business will be affected by many other influences than armament expenditures. The heavier tax burden is likely to cause increased dislocations in non-defense business, and this country will not be insulated from external influences. Everyone is conscious of the problems of adjustment to be solved when the armament is completed, and of the heavy cost of maintaining it. Nevertheless, it is not to be wondered that general opinion considers a severe or prolonged business recession unlikely, after the program once gets going and as long as it lasts.

Corporate Earnings and the Proposed Excess Profits Tax

The draft of the proposed excess profits tax legislation was reported from the Ways and Means Committee to the House of Representatives on August 27, and passed without debate on the 29th. When President Roosevelt proposed a tax of this kind on July 1, it was thought that a bill would be prepared and passed quickly; and the decision was made to combine with it the proposed liberalization of amortization allowances in computing taxes. This has been unfortunate, since there is little controversy over the amortization provisions, while hearings upon excess profits tax recommendations, even before the text of a bill was made available to the public, showed that the fullest possible discussion and study were needed. Hearings on the bill itself, which com-

prises 104 pages, will be limited to three days before the Senate Finance Committee, according to latest information.

It is to be hoped that the coming act will avoid—so far as may be possible—the mistakes in the excess profits taxes of the Revenue Acts of 1917 to 1921, which were severely criticized by government officials, business men, public accountants and tax experts and, after repeated amendments in the effort to make them workable, were completely repealed in 1921. During that period, the uncertainties as to application of the tax caused long delay, imposed heavy burdens upon the tax administration machinery and led to widespread litigation in the courts. A number of cases involving these taxes are, in fact, still unsettled and pending today, after having been in dispute for nineteen years or more.

Provisions of the Bill

In the proposed bill, as revised in Committee, the average of adjusted net income for the four years 1936-1939 is taken as a "base," above which the adjusted net income in 1940 and thereafter is treated as "excess profits" and subjected to additional tax. The corporation has the option of taking as a base the average earnings measured (1) in dollars or (2) as a percentage rate of return on invested capital, but in no case over 10 per cent. One deficit year may be counted as "zero" in computing average earnings.

If the average rate of return method is used, the excess profits are taxed on a sliding scale from 20 to 45 per cent. If the average earnings method is used, the excess profits are taxed on a scale of 25 to 50 per cent, in addition to which the normal tax rate is raised from 20.9 per cent now in effect to 25 per cent.

Companies whose earnings during the base period were depressed are given a minimum credit of 5 per cent on their capital (7 per cent on the first $500,000) in computing the excess profits under option (2).

Discussion of a tax based on this principle has made it clear that the average of earnings for the years 1936-1939 is not a fair basis for all lines of business or for all companies, because of the wide variation always found in the showing of different industries and individual concerns. It is recognized, to be sure, that there must be some base, and that it will be impossible to devise a tax of this kind without inequalities. The question is whether they can be minimized, while at the same time keeping the provisions simple and practicable.

Wide Variations in Business Profits

Although official corporation tax figures are available only through the year 1937, the published reports of leading companies for the four years 1936-1939 illustrate the wide variation in rates of profit and the wide fluctuations that have occurred. The table on the next page summarizes the tabulations of annual reports for these years of over 2,000 leading companies, classified by major industrial groups, that have been presented in the April issues of our Bank Letter, and gives the four-year average. As pointed out heretofore, the reports of leading companies do not indicate the average rate of earnings for business as a whole. Invariably our compilations, covering only these published reports, have shown a higher rate of return than that shown by the Treasury statistics, covering all corporations. The points to which attention is now called, however, are the variations among the groups, and the low returns of certain groups. Furthermore, each group itself is an average, concealing the great variations in the returns of the individual companies to which the tax is applied.

The steel industry, with an average return of but 3.9 per cent for leading companies in 1936-39, is an example of one of the country's most important industries in which average earnings for this period are far below what would be regarded as an adequate return in view of the risks and the constant demand for new capital inherent in the business. A similar example is the railway equipment industry.

Such companies, which experienced little recovery in earnings during the past four years and had little opportunity to recoup their losses and accumulate new capital, are given a minimum credit of but 5 per cent in computing excess profits. This puts them at a disadvantage compared with companies having had good earnings, which are given credits up to 10 per cent.

The 5 per cent limitation would penalize many banks and trust companies also, if their earnings from taxable sources (government bond interest is exempted) should improve. These institutions have had low earnings during the period, and the supervisory agencies have stressed the desirability of building up capital funds so that the latter will stand in higher ratio to deposits. Deposits are expanding steadily, and with conditions as they are there is little opportunity for financial institutions to increase their capital except out of earnings.

Some groups of companies show a relatively high rate of return on stated capital, including chain store and mail order organizations, manufacturers of automobiles, electrical equipment, tobacco products, drugs, soap, cosmetics, soft drinks, beer, liquors, etc. One reason for a high rate of return is a rapid turnover of capital at a small profit margin per unit, with corresponding hazard. Another reason is that these companies do not in most cases include in their capital the intangible value of good-

PROFITS OF LEADING CORPORATIONS FOR THE YEARS 1936-1939

Average Rates in Per Cent of Net Profits to Net Worth. — Net Profits Are as Reported, After Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends. — Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

No. of Cos. (f)	Industrial Groups	1936	1937	1938	1939	Average 4-Years
22	Baking	8.6	7.6	8.6	8.7	8.4
17	Dairy products	9.6	7.8	8.4	9.9	8.9
20	Meat packing	5.5	3.2	–1.1	4.9	3.1
36	Sugar	6.4	6.6	1.6	4.1	4.7
72	Misc. food products	12.0	9.8	9.2	10.3	10.3
167	Total food products	8.6	7.2	5.4	7.8	7.2
20	Soft drinks	31.3	38.5	35.2	37.5	35.6
32	Brewing	15.8	14.2	15.1	17.5	15.6
13	Distilling	22.7	17.0	11.9	10.0	15.4
65	Total beverages	22.8	22.8	21.0	21.6	22.0
23	Tobacco products	12.9	12.9	12.8	13.1	12.9
44	Cotton goods	4.8	4.7	–2.6	3.6	2.6
14	Silk and rayon	9.2	11.1	3.4	11.5	8.8
8	Woolen goods	4.8	–0.9	–6.2	4.3	0.5
25	Knitted goods	6.1	7.0	5.2	7.9	6.5
41	Misc. textile products	11.8	8.8	–0.7	8.9	7.2
132	Total textile products	7.9	6.4	–1.0	6.9	5.0
28	Clothing and apparel	12.0	6.4	2.6	10.4	7.8
8	Leather tanning	4.5	3.4	–9.5	7.7	1.5
20	Shoes, etc.	9.1	7.1	4.2	6.9	6.8
28	Total leather products	8.2	6.3	1.2	7.1	5.7
26	Rubber products	9.9	6.4	5.0	9.4	7.7
40	Wood products	6.5	11.2	1.7	7.0	6.6
73	Paper products	3.6	7.5	3.4	6.4	5.2
34	Printing and publishing	12.2	8.2	3.9	7.2	7.9
44	Chemicals, industrial, etc.	15.3	14.7	7.8	12.9	12.7
27	Drugs, soap, etc.	20.6	18.4	13.9	19.6	18.1
8	Fertilizer	1.5	7.5	3.4	2.2	3.6
14	Paint and varnish	11.5	8.4	3.4	8.1	7.8
93	Total chemical products	14.9	14.4	8.3	13.2	12.7
39	Petroleum products	8.3	10.0	4.6	5.4	7.1
27	Cement, gypsum, etc.	7.2	6.3	4.0	7.5	6.2
33	Other stone, clay & glass	12.2	12.9	5.4	10.1	10.1
60	Total stone, clay & glass	10.3	10.4g	4.9	9.2	8.7
58	Iron and steel	4.5	6.9	–0.2	4.5	3.9
13	Agricultural implements	11.9	13.1	6.6	5.1	9.2
44	Building equipment	8.9	10.1	0.6	6.6	6.5
61	Electrical equipment	11.7	15.2	5.7	10.5	10.8
53	Hardware and tools	12.4	16.5	4.5	11.1	11.1
40	Household equipment	12.8	14.6	5.7	11.7	11.2
114	Machinery	12.5	14.5	6.1	8.6	10.4
19	Office equipment	16.2	20.2	10.0	10.4	14.2
29	Railway equipment	3.2	7.6	–0.8	2.2	3.0
25	Aircraft and parts	7.8	7.2	11.7	21.0	11.9
69	Misc. metal products	12.0	10.7	4.7	9.9	9.3
525	Total metal products	7.9	10.3	2.5	6.7	6.8
26	Automobiles—complete	25.8	18.5	7.3	15.9	16.9
54	Auto equipment	17.0	17.9	–0.2	12.8	11.9
80	Total automobiles	23.8	18.4	6.2	15.4	15.9
27	Misc. manufacturing	13.5	12.7	4.0	9.2	9.8
1,440	Total manufacturing	10.6	10.8	4.6	8.5	8.6
27	Coal mining	0.8*	0.3*	–1.3*	–0.3*	–0.1*
52	Metal mining	8.5*	10.3*	4.9*	7.7*	7.8*
41	Oil and gas	5.9*	9.2*	6.3*	4.8*	6.5*
11	Misc. mining, quarrying	10.5*	13.5*	8.4*	11.2*	10.9*
131	Total mining, quarrying	7.2*	8.7*	4.2*	6.3*	6.6*
138	Class 1 railroads	1.2	0.7	–0.9	0.7	0.4
30	Traction and bus	0.0	–1.6	–2.2	–2.0	–1.4
13	Shipping	4.6	2.2	1.6	4.3	3.2
48	Misc. transportation (a)	4.3	2.3	2.8	5.5	3.7
229	Total transportation	1.2	0.7	–0.9	0.8	0.4
95	Electricity, gas, etc. (b)	5.9	6.5	5.8	6.7	6.2
29	Telephone and telegraph	6.6	6.6	5.8	7.3	6.6
124	Total public utilities	6.2	6.6	5.8	6.9	6.4
19	Chain stores—food	9.7	5.8	7.1	10.4	8.2
48	Chain stores—other	16.8	15.3	11.3	13.3	14.2
32	Department stores	7.3	4.4	3.9	5.7	5.3
5	Mail order	15.2	12.2	9.8	14.0	12.8
45	Misc. and wholesale	7.6	6.9	3.8	5.5	5.9
149	Total trade	12.5	10.9	8.6	11.3	10.8
18	Amusements	9.7	9.4	6.7	6.1	8.0
21	Restaurant and hotel	4.5	1.3	–2.0	0.0	0.9
24	Other business services	4.5	7.2	7.6	10.5	7.4
21	Construction (c)	2.7	2.7	7.3	8.5	5.3
84	Total services and constr.	7.0	7.2	5.9	6.3	6.6
80	Commercial banks	10.3*	8.4	7.4	8.5	8.6
81	Insurance companies (d)	9.4g	8.7	10.6	9.0	9.4
86	Investment companies (e)	7.4	6.9	3.2	5.4	5.7
34	Sales Finance Companies	17.5	17.9	12.7	12.1	15.0
42	Real estate companies	–0.6	–0.5	–0.5	–0.6	–0.5
323	Total finance	9.6	8.6	7.0	7.9	8.3
2,480	Grand total	7.3	7.2	3.8	6.2	6.1

SOURCE: Compiled from tabulations of published shareholders' reports. – Deficit. * Before certain charges. (a) Includes air transport, stockyards, docks, warehousing, pipe lines, etc. (b) Figures refer to shareholders only. Because of the large proportion of bonded indebtedness, actual return on the property investment is less than the above. (c) Includes shipbuilding. (d) Fire and casualty. Figures represent underwriting gain, and net interest, dividends and rents earned. (e) Net income shown as reported, not including such profits or losses on investments sold as were carried directly to surplus or reserve, nor changes in market value of portfolios. (f) Figures from tabulations for 1936 and 1937 are not based upon exactly the same number of companies as those given above for 1938 and 1939, the 1936 tabulation having a total of 2,280 companies and the 1937 tabulation a total of 2,435. (g) Revised.

will, trade names, patents, etc., built up over an extended period of years by heavy expenditures on advertising and research.

It is safe to say that the name and goodwill of many companies are worth more than all of their tangible assets, including plant and equipment, cash, inventory, receivables, etc. Because of these facts, the rate of return on capital tends to be misleading when compared with other lines.

Treatment of Growing Companies

One of the difficult problems in levying an excess profits tax is the treatment of companies which during recent years have had a rapid growth. Despite the limited recovery in corporate earnings generally since the decline following 1929, there has been a marked increase of sales and earnings by numerous companies in such lines as aircraft and parts, commercial air transport, motor transport, bus transport, chemicals and plastics, rayon and other synthetic fibres, alloy steels, paper containers, electrical and radio equipment, heating and ventilating equipment, specialized industrial machinery and office equipment, "supermarkets" for food distribution—to mention only a few lines where the growth is well-known. Moreover, in industries where growth has been slow or negligible, many individual companies have nevertheless made marked progress.

While the obvious hardship of the proposed tax formula as applied to new and rapidly growing companies is to be relieved by allowing them a more liberal base upon which to compute their excess profits, the proposed allowance would still penalize heavily many companies which have been expanding rapidly. These are precisely the companies which need new capital, and which must count heavily upon earnings to finance this growth. The whole question of the relation of the tax to

ability to finance, and thus to the effectiveness of the defense program and the general problem of recovery, needs more consideration than it is receiving.

It is worth pointing out that the proposed tax, while intended to recapture increased earnings resulting from defense orders, is not set up with any direct connection with the defense effort, and is in effect a general revenue measure. It collects equally from companies whose improvement over the base period defined in the bill is in no way related to defense. The principles which should govern revenue measures in the present situation have already been stated in the discussion earlier in this Letter.

Proposals for Securities Act Amendment

The discussions which have been going on between representatives of the Securities and Exchange Commission and investment bankers, security dealers, and brokers, with respect to amendments in the Securities Act of 1933 and the Securities Exchange Act of 1934, have produced their first tangible result during the past month. By means of a rider to the bill regulating investment trusts, which became law on August 22, Congress amended the Securities Act of 1933 to make the requirement of a 20-day waiting period (between the time of registering new securities with the Commission and the offering of such securities to the public) optional with the Commission instead of mandatory. Thus an immediate opportunity is afforded for breaking down one of the barriers to security flotations.

With this promising start, the joint study of further possible modifications of the security regulations will continue. Of course only a beginning has been made, and it remains to be seen whether sufficient progress can be made by this less formal method of procedure and without the usual Congressional hearings and discussions.

The first question which might naturally occur to anyone not intimately familiar with the matters coming within the scope of these Acts is why it seems desirable at this time, when the country's interests are so concentrated on the problem of national defense, to take time to consider revisions of this technical and involved legislation. Is it simply a matter of trying to satisfy the people who are engaged in this securities business and who have been losing money steadily for a number of years past, or are there larger matters of public welfare involved?

The chairman of the House Committee on Interstate Commerce, Representative Clarence F. Lea of California, evidently believes that questions of public policy and welfare are at stake. In a letter to Mr. Jerome N. Frank, Chairman of the Securities and Exchange Commission, he makes the following statement: "A broad problem which confronts the nation is that of encouraging capital investment, the employment of capital, and the consequent employment of labor. Any unnecessary handicaps to the investment of such capital should, of course, be removed." These are phrases which are familiar, and to the expert in finance they convey a clear and convincing meaning, but relatively few people are expert in finance or in economics, and to many it is far from clear just what connection there is between activity in the security markets and the employment of labor and the successful carrying out of a program of national defense.

Deficient in Productive Capacity

It has been a good deal of a shock to most people to learn, as we have learned lately from the exploration of the defense question, that the productive capacity of the United States is at the moment inadequate not only for carrying out rapidly the prospective defense program, but even for putting to active employment the eight or nine million persons who are still out of work. We have been told so frequently that our productive capacity was unlimited, and that the faults in our economic system were solely matters of distribution, that a great many people had come to believe it.

But the fact is that for nearly ten years this country's expenditures for plant and machinery have been insufficient either to maintain the capacity which we had ten years ago or to provide for the added production of goods required for our growth in population and a normal expansion in business. For about ten years we have been using up our productive capacity faster than we have been building it; or, to put it another way, we have been consuming capital faster than we have been creating it.

These facts are no longer a matter of general assertion or hearsay, but are supported by thoroughgoing statistical analysis. In an instructive article on "The Problem of Manufacturing Capacity" in the July, 1940, issue of the Federal Reserve Bulletin, George Terborgh, senior economist of the Division of Research and Statistics of the Federal Reserve Board, points out that even at its post-depression high of 129* in December, 1939, the Board's adjusted index of manufacturing activity was far below the level made possible by our present labor force for which estimates range up to 170 in the index. To reach this level would clearly carry a large number of manufacturing industries, particularly in the heavy lines, far beyond their previous highs into territory for which they are not prepared by recent experience.

Security Markets and Business Activity

The question is, how can the needed expansion of productive capacity be attained? There are many factors, such as labor wage

*Note—The reference is to the former index, which was succeeded by the revised index in August, 1940.

and hour policies, tax policies, adequate planning. One of the key factors will be the functioning of our security market mechanism. Business working on munitions and supplies of various descriptions must be largely financed through the banks and the security markets. Otherwise, the demands upon government finance, already great, will be largely increased, and the danger of inflation and financial disorder will be heightened.

A sound security market is an essential for any great business movement. Business has never reached the prosperity level without an active and strong security market and substantial issues of new securities. As far as the banks of the country are concerned they are in excellent condition to aid in financing the defense program. They are strong, liquid, full of extra cash. But the security markets are another matter, for recent legislation has largely divorced the banks from the security markets. Banks are now forbidden by law from participating in the underwriting or sale of security issues, except for federal and municipal issues; their power to buy securities is by law and regulation more limited than previously; their loans on securities, also regulated, have dwindled to small figures. Hence the banks have little power to aid in maintaining sound security markets.

Tests of Market Capacity

Are the security markets themselves in condition to handle the job they have to do? The behavior of the market in recent months has been in some ways encouraging. In the violent break in security prices after May 10 there was always a market at a price, completely answering by its action those who feared closing might be necessary. It is important, however, not only to have a market at some price, but at fair prices, — a market for new issues that will absorb large offerings without too high cost to the borrower, and a market for outstanding issues which will asborb selling or buying without excessive price movements. Unfortunately, neither condition prevails.

Considering the market for outstanding issues, in ten trading days immediately following May 10, prices of industrial stocks declined 23 per cent compared with a decline of 10 per cent in similar stocks in the more intimately affected London stock market. And this occurred on a turnover of only 1¾ per cent of all listed shares. This is far more volatile action than in the 20s, and other studies, both of declines and advances, reveal a similarly greater instability. This is indeed disconcerting in view of the hope that the restraint on speculation by the Securities Exchange Act would result in steadier markets. Section 2 (paragraph 4) of that Act reads as follows:

> **National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.**

And yet we find today, after the Act has been in effect for six years, that the market is more unstable, and thinner than it was before the Act was passed.

Causes of Instability

The causes of this greater instability of the market are, of course, to a considerable extent matters of opinion; nevertheless, certain direct evidence as to change in the character of the market may be cited.

First, the volume of trading is considerably smaller than it was. In recent years, it has been about half as large as during the late 20s. Measuring trading in proportion to shares listed, it will be found that total sales on the New York Stock Exchange in 1939 were only 18 per cent of the total listings, the lowest rate of turnover for many decades. During the 20s the average shares traded annually were about 100 per cent of the total listings.

Again, there is evidence as to the people who buy stock. According to the Brookings Institution, colleges and endowments hold more common stocks than previously, and the same thing is probably true of trust funds. The fear of inflation and the reduced yield on bonds have led many to buy equities. On the other hand, there is a great decrease in the buyers who are willing to borrow money to buy stocks, people who are willing to take risks for the hope of profit. This is shown by the figures for loans on securities by banks and other lenders which have shrunk from about $8,000,000,000 in the middle 20s and over $15,000,000,000 in 1929, to about $2,000,000,000 today.

While it is doubtful if the two security acts have been as important deterrents to risk-taking as the tax laws or the general atmosphere of fear and repression, there is ample reason to believe that they bear real responsibility for thinness of markets and the scarcity of new issues, which have been both symptoms and causes of repression of enterprise. It would be surprising if this were not so. Both were passed in the heat of discussion of what caused the depression, when penalizing the guilty was more in people's minds than any careful estimate of the economic mechanism. Both were pushed through Congress rapidly and with slight exceptions have not been revised since, although in the past six years the longer standing Federal Reserve Act has been amended fifteen times.

Certain of the abuses of the 20s can never be tolerated again, such as the operations of pools in pushing up prices and then unloading. But the acts in their present form, in attempt-

ing to prohibit abuse, have evidently restricted also wholly legitimate operations necessary for a sound security market.

Evidence in the Securities Act

Most of what has been said up to this point has been directed to the Securities Exchange Act, but the same principles apply to the Securities Act. The results of that Act have been equally disappointing. Partly due to the terms of the Act and partly to other causes, the volume of new publicly offered issues has been smaller than is consistent with economic recovery, or a maximum defense effort. The figures for new productive issues and for total issues have been as follows:

Total Security Flotations and "Productive" Issues (Moody's) 1921-38

(In Millions of Dollars)

Year	Total New Issues	Productive Issues
1921	2,900	2,063
1922	3,287	2,412
1923	3,678	2,667
1924	4,409	3,321
1925	4,956	3,176
1926	5,098	3,145
1927	6,132	3,256
1928	6,725	2,874
1929	9,420	3,205
1930	5,917	3,373
1931	2,786	2,031
1932	1,087	813
1933	644	262
1934	981	444
1935	1,258	524
1936	1,926	771
1937	1,934	1,059
1938	1,807	1,064

Not only has the total volume of issues been restricted, but it is evidently the smaller borrower who has been hurt most. The average issue in the 20s before the passage of the Act was about 2½ millions, compared with about 7 millions since. It is clear that the Act has constituted a hurdle for the smaller business.

Similarly the smaller investor has suffered relative to the larger, for in order to avoid the costs, liabilities and clumsiness of the Act many concerns have been selling their issues directly to a few large buyers. Small investors are having their bonds called and in many cases are getting no opportunity to reinvest in the refunding issues, which go directly to large insurance companies and banks.

All of this specific evidence with respect to the present status of the security markets shows that they are not performing as effectively as is necessary if the United States is to carry through its defense effort promptly and vigorously. There is no simple way of modifying the Acts so as to preserve their beneficial features while eliminating repressive severities. It will require detailed scrutiny of the effects of specific provisions. If through the cooperation of the regulatory authorities, Congress and the banking community, the task can be carried through it will make an important contribution to the defense program and recovery.

Latin-American Economic Problems

Measuring the results against what it set out to do, the Pan-American conference held in Havana July 21 to 30 is entitled to general acclaim. The chief object of the conference was to provide against the possibility of a victorious Germany seizing British, French or Dutch possessions on this side of the Atlantic. The United States made proposals, but the agreement reached was in the fullest sense a joint expression embodying the views of other countries. It took the form, first, of a solemn pact to counter with joint action, or independently if necessary, any projected transfer of sovereignty over the territories held by European powers in the American hemisphere; and it included a nineteen-point convention which covers the steps to be taken, details of the provisional administration of such territories, and their final disposition. This swift agreement, which gives the Monroe Doctrine a stronger continental backing than it has ever before had, is evidence that statesmen and public opinion of all countries are united upon questions involving territorial integrity and security.

Secondly, the conference agreed upon a declaration on inter-American economics, providing especially for study and action on the emergency problems created by the war. The economic declarations are less definite than the political pact, but no more was practicable or expected. An attempt to devise cooperative measures to cover contingencies which are still vague would have been futile.

South America's Trade Interests

The fact that political problems could not be considered without reference to economic problems is obvious. The South American countries do not wish to sever or weaken valued trade relations, and they are more dependent upon foreign trade, and upon Europe, than the United States. They normally export 30 to 50 per cent of their production. In peacetime years half of their exports have gone to Europe and half of their imports have come from Europe. Many of their major products are also major products of the United States, with which we are heavily supplied, and there is no natural market for them here.

Furthermore, South American exports worth $490,000,000, and representing 31 per cent of the total, went to the European continent, as shown by the table following. The war and the extension of the British blockade have virtually destroyed this trade. Exports to Great Britain and the United States have increased; nevertheless, surpluses of some commodities have piled up, with depressing ef-

Distribution of South American Foreign Trade

(All figures in millions; 1936-38 average values)

	Western Hemisphere		Europe		All	
Imports	United States	Other	United Kingdom	Continent*	Other Countries	Grand Total
Argentina	66	40	86	153	67	412
Bolivia	6	7	2	6	2	23
Brazil	68	50	33	116	24	291
Chile	24	11	10	33	9	87
Colombia	40	2	14	26	3	85
Ecuador	4	1	1	5	1	12
Paraguay	1	4	1	2	1	9
Peru	18	7	6	18	5	54
Uruguay	7	10	10	17	11	55
Venezuela	42	1	7	26	4	80
Total	276	133	170	402	127	1,108
Per Cent	25	12	15	36	12	100
Exports						
Argentina	59	55	172	220	32	538
Bolivia	3	1	26	9	....	39
Brazil	117	22	32	125	26	322
Chile	29	4	29	44	45a	151
Colombia	54	6	1	22	12	95
Ecuador	5	2	1	5	1	14
Paraguay	1	4	1	2	....	8
Peru	19	16	18	22	9	84
Uruguay	8	10	18	27	7	70
Venezuela	36	180b	11	13	....	240
Total	331	300	309	489	132	1,561
Per Cent	21	19	20	31	9	100

*Excluding Soviet Russia. a—Chiefly nitrate of soda and iodine shipped for unspecified destinations. b—Chiefly petroleum shipped to Curacao and Aruba (Dutch West Indies) and exported to the United Kingdom and Continent.

fects upon markets, and unless conditions change before the next crops are harvested the situation in other commodities will be critical.

Supplies of foreign exchange (particularly dollars) available to the South American countries to pay for imports and meet other requirements are diminishing. It has been calculated, for example, that each decline of one cent per pound in coffee reduces Colombia's available foreign exchange at the rate of $5,000,000 annually, and coffee has dropped about 4½ cents in a year. Colombia has borrowed $8,000,000 from the Export-Import Bank at Washington and restricted non-essential imports to a minimum. Venezuelan oil exports have been disappointing, and the ending of a barter agreement with Germany has reduced exports and compelled her to find free exchange for the corresponding imports. The same situation affects Chile. Brazilian coffee shipments have fallen and the sale of cotton is slow and uncertain. The details differ, but all the countries are affected. Some thought they would benefit temporarily from war trade, but in fact the inescapable losses due to the war are being incurred now.

These are facts which were bound to be of chief concern in a conference dealing with American-European relations. The Latin-American nations are unanimous in wanting security. Individually they also want to preserve their trade. Their international policies must take trade into account. The United States, whose policy is to promote a free world trade, cannot be other than sympathetic with their difficulties.

Declaration Upon Inter-American Economics

The economic declaration made by the conference properly recognizes that the problem includes two distinct though related parts. First, it states that the American nations maintain their adherence to liberal principles of commerce, and that they propose to apply these principles to their mutual relations as widely as circumstances permit, and to all their commerce as soon as non-American countries are disposed to re-establish them. It will be appropriate to refer to these declarations after the war. They constitute a clear statement that so far as the preferences of the American countries go they are indisposed to barter and the equivalent totalitarian methods of which they have had experience.

The second part of the problem, the disruption of South American exports by the war, is concrete and urgent. The declaration calls for amplification of the activities of the inter-American Economic and Financial Consultative Committee, created at the Panama Conference last Fall. It charges this committee to study measures whereby living standards can be raised, internal consumption of export products increased, and interchange among the American nations advanced; to create instruments of inter-American cooperation for warehousing, financing and transitory disposition of surpluses; to formulate programs for the distribution of surplus products as humanitarian measures, and for promoting economic development with suitable financial aid.

These recommendations are all appropriate and in principle non-controversial. Meanwhile President Roosevelt has asked Congress for legislation making an additional $500,000,000 available to the Export-Import Bank, to enable the Bank to make loans to governments and governmental agencies of other western hemisphere countries. The President's request was made during the conference, and was a commitment as to the Administration's attitude, although naturally not binding on the Congress. One of the several purposes of the proposal, as expressed in the President's message, is to finance indirectly the "handling and orderly marketing of some part of their surpluses." The bill at this writing has passed the House of Representatives and is expected to become law.

Role of the United States

The role to be played in economic affairs by the United States, whose paramount interest is in defense and security, is one for the

gravest consideration. The first question is whether this country, accepting the President's leadership, should help in dealing with the immediate difficulties. While of uncertain duration, the emergency is obviously temporary, inasmuch as European needs for the food and supplies which are piling up on this side of the ocean will some time be immense. This is one justification for support to bridge over the period of disruption.

Second, the economic situation in the United States is affected. Pressure to sell products competitive with ours, which formerly went to the Continent, depresses our markets, as witness the sharp decline in hide prices, from 13½c on May 10 to 9¾c, due to weakening of the Argentine market and larger imports into the United States. Lead prices are down, due to excessive Mexican and Peruvian supplies. The loss of exports to Europe diminishes the ability of South American countries to buy goods here, since they have normally covered part of their payments to the United States by converting the proceeds of sales to Europe. At the same time the proceeds of exports of certain commodities to Great Britain, notably Argentine and Uruguayan meat, by agreement have been blocked in pounds sterling, usuable only in Great Britain, which reflects the British necessity to conserve foreign exchange. Inability to convert these British funds into dollars prompted Argentina in June to arrange a credit of $20,000,000 with the Export-Import Bank.

In the third place, defense of a hemisphere is a common enterprise. The United States asked from the conference only cooperation in the common interest, and sought nothing for itself. The Latin-American countries have confidence in Secretary Hull, and have learned that this country has no imperialistic aims and will take no selfish advantage of their necessities. Manifestly, however, if the United States contributes financial aid it is better able to ask for equivalent contributions to defense. Negotiations are in progress for naval bases in British possessions. Whether the use of bases on the Continent of South America would be advisable is for the general staffs to decide, and we do not presume to offer an opinion. The question may be typical, however, of those which come up as defense is explored.

These are the arguments for the Export-Import Bank proposals. There is also much to be considered on the other side. Even though the United States has interests at stake, in the long run each country must bear its own losses resulting from the war; and for the most part it appears that each South American country desires to make its own adjustments and minimize its losses in its own way, appealing only for such financial assistance as will spread the burden over a longer time. As a general rule resort to loans for economic relief is simply taking the path of least resistance. Loans open no new markets to the borrower, they add to his burdens for the future, and in the long run they are likely to bring him little benefit.

The United States has had experience with loans to support commodities, and the best that can be said of them is that the need tends to become perpetual unless production is concurrently controlled. It is not to be expected that independent countries will allow their production or trade policies to be governed by an outside authority. Plainly they are the business of each country. Many of the South American countries are already making loans out of their own resources, and controlling supplies for market in one way or another.

Proposals to Purchase Commodities

It has been proposed also that the United States should purchase appropriate quantities of commodities which can be used here, though not now needed, and carry them as a reserve; and probably more will be heard of this proposal. It might apply, for example, to Chilean nitrates, which are fertilizers and are needed to make explosives; to Argentine wool and hides, of which this country is regularly an importer; to Peruvian long staple cotton, replacing Egyptian cotton here; and to a considerable number of less important commodities which this country regularly imports.

It must be recognized that any purchase plan would involve dangers. Unless favored by unusual good fortune, losses would probably be incurred. Any effort to withdraw surpluses from markets tends to stimulate over-production and lead to still larger surpluses. The stocks withdrawn, if their disposition is uncertain, are an incalculable and disrupting element in normal trade. Moreover, a commitment by one country for the benefit of another may be interpreted as implying commitments for the future and considered a form of subsidy that cannot be withdrawn without repercussions.

These hazards make it plain that any program of purchases should be clearly and definitely limited as to time, as to the quantities of commodities involved, and as to the prices fixed; and that the disposition of the stocks in orderly manner should be provided for. The governing principle should be that the market support should bridge over a temporary situation and should not be construed as a substitute for natural trade.

If a purchase program could in fact be arranged within these limitations it appears from the figures that a great deal of aid in the emergency could be given with comparatively small sums. Calculating the average exports of Chilean nitrate, for example, at 1,-

600,000 tons, a contract for 400,000 tons would make up for most of the possible loss of sales for the year 1940, and would support normal operations in the nitrate industry. The cost in Chile at $12 a ton would be $4,800,000.

Purchases of wool would run to considerably higher totals, if lost European markets were to be wholly compensated for; but this country is normally an importer of wool, and possibly could increase its consumption of Argentine carpet wools in place of Oriental wools now inaccessible. The same comments apply to hides, cocoa and long staple cotton, and the amounts that would give relief would not run to many millions. In coffee substantial sums (perhaps $25,000,000 to $30,000,000) would be required to absorb the major part of the 5½ million bags of Brazilian coffee and 750,000 bags of Colombian coffee normally exported to the Continent, and the disposition of the stocks acquired would present difficult problems. The coffee surplus is chronic in Brazil, however, and for years has been dealt with locally.

What the United States could do with the huge surplus of Argentine corn is not clear, since we have a corn surplus problem also; the Argentine Government is lending growers 15c a bushel to keep corn on the farm. Argentine wheat and flaxseed present no great difficulties at present, as stocks are not abnormal. The next crops, however, will come to market with very unfavorable prospects, if the war continues.

We lack space for further elaboration of the facts in each commodity market. It is sufficient to say that the situation as it now exists requires no grandiose scheme for its alleviation. Nor are the amounts of money needed for "storage and orderly marketing" as large as many people have assumed. It remains to be seen how far they are beyond the means of the countries concerned, and whether the requests for assistance from the United States will mount to large sums, as compared with other government spending for economic relief. One thing is certain: the greater the scale of proposed assistance the more likely it is to be wasteful and empty of ultimate benefit.

The cartel proposal, by which Latin-American commodities normally exported to Europe would have been impounded in a huge pool financed by the United States, which would have controlled their sale, has perished unregretted. The proposed obligations to be assumed by this country were excessive and the plan probably unmanageable; and to the Latin Americans the surrender of authority over their trade was objectionable. With the nature of post-war trade undefined, and the feared "totalitarian threats" still wholly in the realm of surmise and speculation, it would be premature to begin combating them by setting up Pan-American totalitarian measures.

Approaches to a Broader Trade

Two fundamental facts underlie trade relations between the United States and Latin America. One is the general truth that all trade must be two-way in character. The other is the fact, already pointed out, that many products, particularly of South America, are competitive with rather than complementary to United States products, and that the major trade of their producers therefore is with Europe. Efforts to increase Pan-American economic solidarity must be in harmony with these facts.

Three lines of approach may be suggested. One is that increased standards of living everywhere in the hemisphere would absorb more of the raw materials in which the surpluses exist. Greater industrialization would raise living standards in South America, and improved roads and other communications would enlarge the internal trade. The United States, which has management, technical ability and capital goods to export, can aid productive economic development, and in the present situation opportunities for sound capital investments and intermediate term loans, by the Export-Import Bank or private interests, are less likely to be overlooked than ever before.

The second approach is the development in Latin America of new products not competitive with United States products, and expanded output of articles which we now draw from more remote sources. The number of commodities with possibilities for development is long, but the possible volume with some exceptions is small, and progress is necessarily slow.

The third approach is to determine whether more Latin American products, although competitive with American agriculture or industry, could be admitted into this country without disrupting domestic production to an extent that would offset the general benefits. It cannot be said too often that closer economic relations must begin with larger imports from Latin America. The larger exports would follow.

There is no over-all or quick and easy solution to the problem. Natural and well-developed trade relations can shift only gradually and in response to patient, careful and mutually sympathetic effort. But if the American nations approach the problem in that manner they unquestionably will find that they are dealing not merely with a possibly critical situation, but with a great opportunity.

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